FINRA's New PFOF
And Best Execution Guidance

FINRA Fines
Robinhood $70M

FINRA Posts Another
Best Execution Notice

By u/dlauer

FINRA's New PFOF and Best Execution Guidance

Education | Data

FINRA has just issued new guidance"reminding" firms of their obligations of best execution when accepting or paying payment for order flow (PFOF). There are definitely some key things to see here. It's clearly focused on recent issues with Robinhood, and how they give hardly any price improvement, while accepting huge amounts of PFOF.

> Longstanding SEC guidance generally holds that "a broker-dealer does not violate its best execution obligation solely because it receives payment for order flow or trades as principal with customer orders."[12] However, the SEC also has stated that payment for order flow may "raise concerns about whether a firm is meeting its obligation of best execution to its customer."[13] And ultimately, the SEC has stated that "a broker-dealer must not allow a payment or an inducement for order flow to interfere with its efforts to obtain best execution."[14]

FINRA is re-iterating that best execution and best price trumps payment and inducements. FINRA then reminds firms of a notice sent in 2015, and lays out that firms have to prioritize price improvement opportunities:

> FINRA has provided member firms with detailed guidance on the execution quality review standards imposed by Rule 5310, including most recently in *Regulatory Notice 15-46*. As discussed more fully in *Regulatory Notice 15-46*, order-by-order review of execution quality is increasingly possible for a range of orders in equity securities and standardized options, and it is required for any orders that a member firm determines to execute internally.[17] Where member firms may choose not to perform an order-by-order review, they must have procedures in place to ensure that they periodically conduct regular and rigorous execution quality reviews on a security-by-security, type-of-order basis.[18]
>
> Under Rule 5310, when conducting their reviews of execution quality, member firms should consider: (1) price improvement opportunities (*i.e.*, the difference between the execution price and the best quotes prevailing at the time the order is received by the market); (2) differences in price disimprovement (*i.e.*, situations in which a customer receives a worse price at execution than the best quotes prevailing at the time the order is received by the market);[19] (3) the likelihood of execution of limit orders; (4) the speed of execution; (5) the size of execution; (6) transaction costs; (7) customer needs and expectations; and (8) the existence of internalization or payment for order flow arrangements.[20]
>
> FINRA discussed these and additional execution quality review factors in *Regulatory Notice 15-46*, including areas of particular focus where inducements such as payment for order flow arrangements or internalization exist. For example, the possibility of obtaining price improvement is a heightened consideration when a member firm receives payment for order flow.[21] In other words, it is especially important under these circumstances to determine that customers are receiving the best price and execution quality opportunities notwithstanding the payment for order flow.[22] As FINRA has reminded member firms, when a firm is routing order flow for automated execution, or internally executing such order flow on an automated basis, the SEC has indicated that simply obtaining the best bid or best offer may not satisfy a firm's best execution obligation, particularly with respect to small orders.[23] In addition, FINRA cautioned that member firms would not satisfy their duty of best execution if they do not compare the execution quality they receive under their existing order routing and execution arrangements (including the internalization of order flow) to the quality of the executions they could obtain from competing markets.[24]

I think the next part is one of the key passages. It's directly targeted at internalizers, and goes to the practice of them offering to give brokers either PFOF or price improvement - FINRA appears to be saying that this is no longer allowed:

> Importantly, inducements such as payment for order flow and internalization may not be taken into account in analyzing market quality.[25] Accordingly, for member firms that receive payment for order flow, FINRA has stated that such firms should carefully evaluate the impact of the practice on execution quality.[26] Similarly, firms that provide payment for order flow for the opportunity to internalize customer orders cannot allow such payments to interfere with their best execution obligations.[27] In other words, order routing firms and firms receiving customer orders from other firms for handling and execution must regularly evaluate whether reliable, superior prices are readily accessible for the customer orders they handle, and these firms may not negotiate the terms of order routing arrangements for those customer orders in a manner that reduces the price improvement opportunities that otherwise would be available to those customer orders absent payment for order flow.[28] Such a practice would not be consistent with the requirement that member firms assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.[29] It also would not satisfy a member firm's obligation to use reasonable diligence to ascertain the best market for a security, and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.[30] Ultimately, as FINRA has noted, the existence of an order routing, handling and execution arrangement between firms in no way alters either firms' best execution obligation to analyze and review the execution quality of the orders routed pursuant to the arrangement.[31]

I believe this suggests that FINRA is putting firms on notice that new rules are coming, and they need to change their practices right away. This is a good step in the right direction, but it will be wholly inadequate without new rules and stepped up enforcement.

FINRA fines Robinhood $70M

News | Media

FINRA just announced a major enforcement action against Robinhood for $70M, which breaks down to $57M fines and $12.6M restitution to clients. Here's the press release, and the full action.

This is a pretty standard enforcement action - Robinhood neither admits nor denies the findings, and it's essentially a slap on the wrist. Robinhood collected $331M in PFOF in Q1 2021.

Robinhood intentionally mislead their customers:

> - Robinhood falsely told "Robinhood Instant" customers that they had to upgrade to "Robinhood Gold" to trade on margin when, in fact, Robinhood allowed "Instant" customers to place options trades that could trigger the use of margin.
> - Robinhood falsely told "Robinhood Gold" customers that they could "disable" margin in their accounts when, in fact, Robinhood allowed "Gold" customers to place options trades that could trigger the use of margin even after they had "disabled" margin.
> - Robinhood displayed inaccurate cash balances to certain customers. Some inaccuracies were significant. For example, Robinhood displayed to many customers negative cash balances that were twice as large as they actually were.
> - Robinhood provided false information to customers about the risks associated with certain options transactions. For example, Robinhood falsely told customers that they would "never lose more than the premium paid to enter [a] debit spread" when customers could, and many did, lose vastly more than the premiums they paid.
> - Robinhood issued to certain customers erroneous margin calls and margin call warnings, telling them that they were in "danger of a margin call" when they were not.

There are many other violations in the order. Among them:

- Failure to exercise due diligence before approving options accounts
- Failure to supervise technology critical to providing customers with core broker-dealer services
- Failure to create a reasonably designed business continuity plan
- Failure to report customer complaints to FINRA

- Failure to have a reasonably designed customer identification program
- Failure to display complete market data information

This is a pretty disturbing set of violations, and honestly it's surprising that they can continue to operate as a broker-dealer. This is an important enforcement action, but overall I'd call it a disappointment in terms of the cost to Robinhood and the remedial actions they need to take.

FINRA Posts Another Best Execution Notice

DD

FINRA has just put out another notice on Payment for Order Flow and Best Execution. They are reminding broker-dealers of their best execution obligations. There are a couple of interesting things in this notice, although I'm not optimistic this will lead to anything material.

For one, they italicize *best* execution here, which is interesting:

> In the context of small-size retail customer orders, the SEC and FINRA have noted the ready accessibility of prices better than the prevailing best quote (the "national best bid and offer," or the "NBBO"), and SEC rules require information about the frequency and magnitude of price improvement relative to the NBBO to be included in monthly public reports.[3] While the SEC and FINRA have recognized that best execution is not concerned solely with price, price is undoubtedly a key concern for most retail customers.[4] As discussed further below, compliance with Rule 5310 requires member firms to regularly evaluate the availability of reliable, superior prices and to assure that order flow is directed to markets providing the most beneficial terms for customer orders. Accordingly, member firms' best execution procedures must be reasonably designed to identify the *best* prices and obtain *best* execution for customer orders under prevailing market conditions.

I've often criticized (including to FINRA and SEC personnel) the fact that most brokers are only identifying good-enough prices and good-enough execution, not best execution. It looks like FINRA is echoing that here.

The most important passage is this one, in my mind:

> Importantly, inducements such as payment for order flow and internalization may not be taken into account in analyzing market quality.[25] Accordingly, for member firms that receive payment for order flow, FINRA has stated that such firms should carefully evaluate the impact of the practice on execution quality.[26] Similarly, firms that provide payment for order flow for the opportunity to internalize customer orders cannot allow such payments to interfere with their best execution obligations.[27] In other words, order routing firms and firms receiving customer orders from other firms for handling and execution must regularly evaluate whether reliable, superior prices are readily accessible for the customer orders they handle, and these firms may not negotiate the terms of order routing arrangements for those customer orders in a manner that reduces the price improvement opportunities that otherwise would be available to those customer orders absent payment for order flow.[28] Such a practice would not be consistent with the requirement that member firms assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.[29] It also would not satisfy a member firm's obligation to use reasonable diligence to ascertain the best market for a security, and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.[30] Ultimately, as FINRA has noted, the existence of an order routing, handling and execution arrangement between firms in no way alters either firms' best execution obligation to analyze and review the execution quality of the orders routed pursuant to the arrangement.[31]

Let me explain something quickly. When Citadel or Virtu gets an order from a retail broker, they have a profit margin on that order. Let's say the spread is $0.02 wide, and they think they can make $0.015 per share, on average. Of that

$0.015, they want $0.01 per share as profit to keep, and are willing to pay back $0.005 per share to the broker. (all of these numbers are made up, for illustrative purposes)

Citadel and Virtu don't care if they are sending that $0.005 per share to the broker as price improvement (where the retail investor receives it) or payment for order flow (where the broker receives it).

FINRA is saying that brokers CANNOT negotiate higher payment for order flow instead of price improvement. This is actually a big deal, because it's the foundation of Robinhood's business model. If they have to provide the same price improvement as, say, Fidelity, who doesn't accept PFOF, then they'll go out of business. The fundamental paradox between a firm that accepts PFOF and one that doesn't is that the firm that doesn't gives its customers better execution prices, and therefore better execution. So a firm that accepts PFOF, by definition, cannot be providing *best* execution. It's mathematically impossible.

This could be an important step. Or it could be a regulatory nothingburger. But if it's a nothingburger, it could provide some fuel for class action lawsuits down the road, so ultimately this is a positive development.